Southwestern Bell

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Federal Communications Commission
Office of Secretary

April 29, 1997

EX PARTE

Durward D. Dupre
Vice President-
Associate General Counsel

The Honorable Reed E. Hundt, Chairman
The Honorable James H. Quello, Commissioner
The Honorable Susan Ness, Commissioner
The Honorable Rachelle B. Chong, Commissioner
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: *In the Matters of Federal-State Joint Board on Universal Service and Access Charge Reform, CC Docket Nos. 96-45 and 96-262*

Dear Mr. Chairman and Commissioners:

On April 8, 1997, the Competition Policy Institute (CPI) submitted a document entitled "Legal Memorandum for the Competition Policy Institute Concerning the Legal Authority of the Federal Communications Commission to Prescribe Reductions in Access Charges." An analysis of CPI's document yields a number of inconsistencies and errors in the analysis provided to you; however, given the short time available before the Commission ends the time in which permitted *ex parte* communications can take place, Southwestern Bell Telephone Company, Pacific Bell, and Nevada Bell (the Companies) will not respond with a lengthy memorandum of its own. Instead, we have attached a partial list of a few significant errors in the CPI memorandum.

In short, CPI misconstrues case law to argue that compensation from other services will prevent an unconstitutional taking if the Commission prescribes reductions in access charges to forward-looking costs. Secondly, CPI ignores applicable precedent to argue that local exchange carriers (LECs) should not recover their historical costs.

Pursuant to Commission Rule 1.1206(a)(1), 47 C.F.R. § 1.1206(a)(1), two copies of this letter and the attachment are submitted to the Secretary for inclusion in the record of this proceeding.

Sincerely,

One Bell Center
St. Louis, MO 63101

Phone 314 235-4300

Attachment

April 29, 1997

RESPONSE TO LEGAL MEMORANDUM OF THE COMPETITION POLICY INSTITUTE

The Competition Policy Institute's legal memorandum cannot be relied upon to justify the prescriptive reductions in interstate access charges that it advocates. Following is a partial list of significant errors that a brief review of the legal memorandum reveals:

Error No. 1: CPI wrongly argues that "The LECs cannot succeed in a taking claim based simply on the imposition of a different cost methodology."

CPI's statement is initially flawed because it attempts to answer a mischaracterization of the LECs' argument: that the LECs have based their "takings" arguments "simply on the imposition of a different cost methodology." It is not "simply" the imposition of a different methodology that causes the Companies great concern, but also the impact of that methodology. The NPRM itself acknowledges that the key question is whether the difference in rates occasioned by the imposition of a different cost methodology should be recovered or not.[1] The NPRM discusses in great detail possible methodologies under which the LECs would be allowed to recover such a difference. It is the possibility of not recovering this difference that implicates a "taking," not just the use of a new cost methodology. Notably, CPI does not cite to any LEC pleading that argues that a change in cost methodology alone is a "taking."

Some case law indicates, however, that a change in cost methodology itself would be improper. In Duquesne Light, the Supreme Court stated:

> The risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks. Consequently, a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions.[2]

Thus, any change in rate methodology must itself be scrutinized. It is noteworthy that this strong language comes from the Duquesne Light case -- the same case that CPI claims supports its position.

Error No. 2: The CPI memorandum misreads the Duquesne Light precedent.

CPI cites Duquesne Light as supportive of its proposition that the "total effect" of prescribing access charge reductions based on forward-looking costs would not constitute a taking. CPI states that "the facts in Duquesne Light are particularly analogous to the access charge issue." As

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[1] NPRM at Section VII.

[2] Duquesne Light Co., et. al. v. Barasch, et. al. 488 U.S. 299, 315 (1989).

noted above, Duquesne Light does not clearly support CPI's position. CPI also chooses to ignore the discussion of that case by SWBT in its Reply Comments submitted in the access charge reform docket:[3]

> The relevant law read in context, states otherwise. The first quote of SCA [State Consumer Advocates] is to Duquesne. While the quote is accurate, Duquesne also noted that the "regulatory scheme" under which the investments in question were denied, did not raise any claim that the "financial integrity" of the companies was jeopardized or that shareholders would not be adequately compensated. The reason these arguments were apparently not made in Duquesne is that the Pennsylvania regulatory scheme provided other methods of recovery to the companies so as not to depress their earnings below a constitutionally infirm level.
>
> Contrary to SCA's and AT&T's positions, using revenues from unrelated sources to "prop up" underrecovering rate elements is not how the Commission engages in ratemaking. The Commission has reviewed earnings in categories to determine whether companies are overearning. As the Commission has itself described its methodology:
>
>> Under the category-by-category approach of both the 1981 prescription and Phase I Order, AT&T is afforded a reasonable opportunity to recover all of its costs, including a return on capital. There is no guarantee of any return, nor is the "opportunity" without reasonable restrictions. We have determined, for example, that it must recover its capital costs by earning a reasonable return on each of its services; it cannot offset deficient private line earnings with excessive earnings from switched services. Our obligation under the Communications Act to ensure just and reasonable rates compels us to prevent one class of customers from paying excessive rates or cross-subsidizing other customers.
>
> Thus, the scheme used by the Commission must pass Duquesne muster by requiring that the appropriate ratepayers pay the proper amounts. The Commission cannot require one group of ratepayers (i.e., customers of unregulated services) to pay for investment that is now being used to provide regulated service.

In short, without relating the precedent cited by CPI to the relevant Commission precedent on ratemaking (i.e., that a carrier "must recover its capital cost by earning a reasonable return on each of its services") CPI's discussion of the "total effect" cases must be disregarded.

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[3] In the interest of brevity, several footnotes have been omitted.

Error No. 3: CPI negligently states that it is "not aware of a single case in which the Federal Courts have found a taking involving rate regulation since Hope Natural Gas."

As one example to disprove CPI's point, one may examine the case of Guaranty Nat'l Ins. Co., et al. v. Gates, 916 F.2d 508 (9th Cir. 1990). In this case, the U.S. Court of Appeals for the Ninth Circuit determined that a Nevada insurance rate setting practice created by statute would result in constitutionally infirm rates as it provided no "mechanism to guarantee a constitutionally required fair and reasonable return."

This error alone casts serious doubt as to the quality, thoroughness, and credibility of CPI's research.

Other cases cited by the Companies and USTA, among others, reveal numerous limits on the rate setting powers of administrative agencies. While not all of these may implicate "takings" law, per se, many of these limitations, if not all, are based upon the constitutional requirement that "private property [shall not] be taken for public use, without just compensation." This principle is the basis for all governmental rate regulation.

Error No. 4: CPI incorrectly asserts that the imposition of price cap regulation is inconsistent with the recovery of "historical costs."

Pages 7 and 8 of CPI's memorandum claim that incentive regulation in general, and the introduction of risk in the ability of LECs to recover their costs, "makes it difficult for the LECs to sustain an argument . . . that the government has guaranteed them a certain cost recovery level."

This argument ignores fundamental elements of the Commission's price cap plan for LECs. The LEC price cap plan does reflect costs, it just does so in a different way than rate of return regulation.[4] First, the CPI memorandum ignores the establishment of a lower formula adjustment mark in the price cap plan.[5] The Commission was careful to set the lower end adjustment mechanism so that the return to LECs under the plan would not likely be confiscatory. This directly contradicts CPI's assessment of LEC price cap regulation as inconsistent with recovery of historical costs. The rate base against which the rate of return was measured to trigger the lower formula adjustment was, in fact, the rate base set by the Commission's uniform system of accounts -- the same system under which the LECs claim their historical costs today.

Second, CPI's memorandum ignores the option allowed by the LEC price cap plan to file

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[4] "[P]rice cap rates do reflect costs and take profits into account, albeit in a different manner than do rate of return rates." LEC Price Cap Order at paragraph 405.

[5] LEC Price Cap Order at paragraphs 164 through 165.

above cap rates in the event that the price cap rules would "have the effect of denying an LEC the opportunity to attract capital and continue to operate, despite the low end adjustment mechanism and the opportunity provided the LEC to increase its earnings through greater efficiency."[6] Certainly, the Commission's concern with avoiding a confiscatory result by including both a low-end adjustment mechanism and an option for above-cap filings, signals a direct contradiction to CPI's argument that the existence of LEC price cap regulation "makes it difficult for the LECs to sustain an argument in 1997 that the government has guaranteed them a certain cost recovery level." On the contrary, the care with which the LEC Price Cap Order was constructed in this regard strongly supports the recovery of historical costs.

CONCLUSION

While this list of errors is not meant to be exhaustive, it signifies that the CPI memorandum cannot be relied upon by the Commission in any way to support prescriptive reductions in interstate access charges.

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[6] LEC Price Cap Order at paragraph 304.